# Economic commentary

## Introduction

Tensions, both in the United Kingdom and in overseas countries, appear to have markedly increased over the past year and a half. Taking a somewhat longer perspective than has been usual in the recent past, this commentary offers a review of economic developments over this period.

Inflation in the United Kingdom has accelerated sharply from its low point in 1978, although many special factors account for much of the 22% rise in retail prices over the year to May 1980. In these circumstances, it becomes all the more important to control the growth of the money stock, and to maintain assurance of underlying monetary stability. At the same time, the acceleration in inflation has complicated the task of the authorities. One consequence has been the rise in minimum lending rate (MLR) to 17% (in November 1979), and the high level of nominal interest rates since then.

Rising inflation against a policy of monetary restraint is bound to worsen prospects for the real economy in the short term. Signs of a slowdown in demand and activity accumulated through 1979, and substantial falls in output and employment are likely as the recession develops. With domestic costs moving yet further out of line with those of competitors and with a strong exchange rate—reflecting in part the United Kingdom's position as an oil producer—the financial position of industry has come under increasing strain. In turn, the financial deficit of industrial and commercial companies has been one of the principal reasons for the rapid expansion of bank lending; with this component growing so fast, determined action by the authorities has been necessary.

The deterioration in UK performance and prospects is paralleled in other industrial countries. World inflation was relatively low in 1978, helped by weak commodity prices and a slack oil market. A reversal of the favourable movement of commodity prices—affected by stronger activity in OECD countries in 1979—and the approximate doubling of international oil prices since late 1978 have led to a marked acceleration in inflation. In the United States, the long-expected recession began in the first half of 1980; and other industrial countries face the prospect of low or negative growth and rising unemployment.

Though there are similarities between economic developments in the United Kingdom and those in other countries, some aspects of UK performance are particularly disturbing. The upswing in demand in the United Kingdom in 1978 and the first part of 1979 had only a limited effect on output and activity. A very high proportion of the increased expenditure was met from imports; and the balance of payments on current account swung to a deficit of about £2¼ billion in 1979, in spite of approaching self-sufficiency in oil production. The exchange rate, meanwhile, has been strong. As a result, the impact of cost increases on the company sector has been particularly severe, while the real incomes of consumers have, to an extent, been protected.

The most unfavourable aspect of UK performance is in the movement of earnings. The response of wages to the oil-induced price rises in most other industrial countries has been muted. In this country, by contrast, pay settlements have accelerated even in comparison with the 1978/79 pay round, and average earnings have risen at about the same rate as retail prices, notwithstanding the fact that the year-on-year change in retail prices has been overstating the underlying rate of price inflation because of the switch from direct to indirect taxation in the June 1979 Budget.

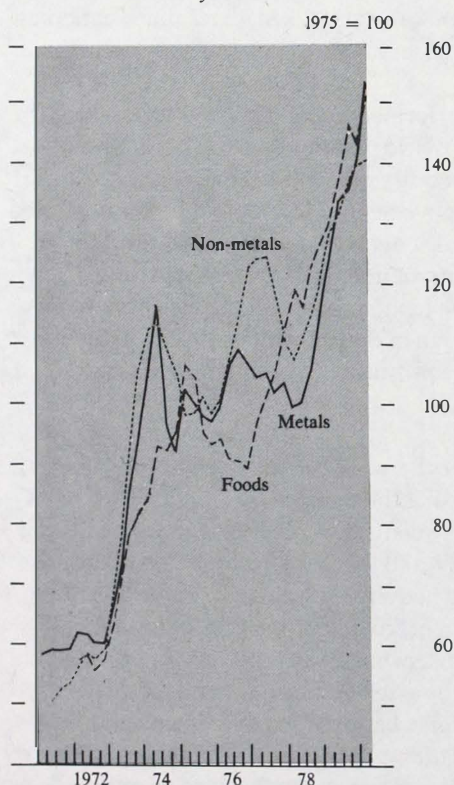
**Monetary targets — the background**

Per cent

| | Sterling $M_3$ (annual rate) | | Prices(a) | GDP(b) | Minimum lending rate: end-period |
|---|---|---|---|---|---|
| | Target | Outturn | | | |
| Financial years | | | | | |
| 1976/77 | 9–13 | 7.7 | 17.4 | 3.1 | 10.5 |
| 1977/78 | 9–13 | 16.0 | 7.9 | 1.9 | 6.5 |
| 1978/79 | 8–12 | 10.9 | 10.1 | 3.0 | 13.0 |
| Oct. 1978–Oct. 1979 | 8–12 | 13.3 | 17.2 | 2.1 | 14.0 |
| June 1979–April 1980 | 7–11 | 10.0 | 22.9(c) | 0.8(d) | 17.0 |

(a) Retail price index: change over twelve months.
(b) Output-based measure, four quarters on previous four quarters.
(c) Annual rate.
(d) Second half of 1979 over second half of 1978.

**Commodity prices** *have risen sharply over the last two years.*(a)




(a) Weighted by shares of UK imports in 1975.

## Monetary policy and inflation

Since 1976, successive governments have sought to achieve pre-announced targets for the growth of the money supply, broadly defined (sterling $M_3$), with the aim of bringing inflation under control. The target range for monetary growth has been progressively reduced from an annual rate of 9%–13%—when targets were first adopted in 1976—to an annual rate of 7%–11%, first set in June 1979 and currently relating to the period February 1980 to April 1981. The medium-term financial strategy, announced in the March Budget, envisages further reductions in the target rate of money supply growth over the next few years.

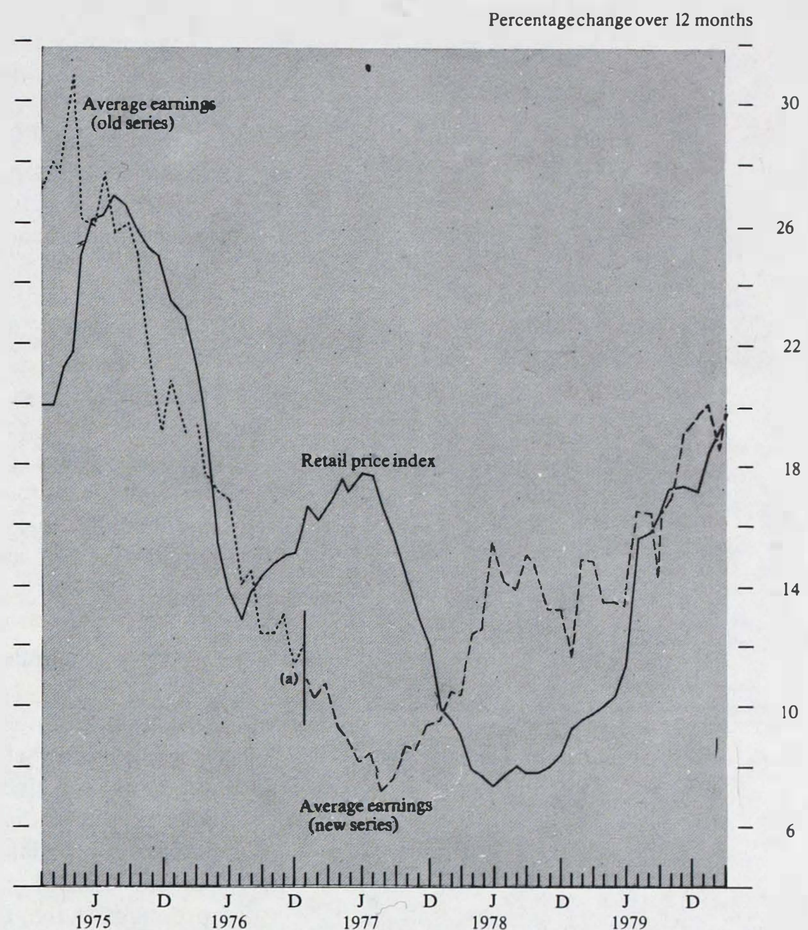
The initial phases of this policy of monetary restraint were associated with falling inflation. The rate of increase in the retail price index fell from 15.1% on a twelve-month basis in December 1976 to 8.4% in December 1978. The marked fall in the pace of inflation in 1978 was influenced by previous pay restraint and by the easing of world inflation linked in particular to the weakening in the markets for energy (real oil prices fell by some 15% between end-1977 and end-1978). Lower inflation in the United Kingdom was also encouraged by the lagged effects of the appreciation of sterling from 1977 onwards, itself in part a consequence of monetary restraint.

Although there could be no confidence that all these favourable factors would persist, it seemed reasonable to hope in 1978 that the fall in price inflation and the substantial rise in real earnings would be reflected fairly quickly in a slower pace of pay settlements in the 1978/79 pay round. In the event, the favourable conjuncture did not lead into the virtuous circle that had been hoped for. It is not clear how far the subsequent rise in wage inflation reflected frustration with the previous pay round (on the part of employers or employees, or both) or expectations that inflation was about to rise again. The 1978/79 pay round was marked by major industrial disruption and a rise rather than a fall in the rate of settlements. With earnings rising by some 16% overall—and little scope for compression of corporate margins—it was only a matter of time before the deterioration showed up in retail prices.

The growth of sterling $M_3$ from April 1976 to April 1979 averaged $11\frac{1}{4}$% per annum. Over this period, however, continuing monetary restraint was overlaid by influences, first favourable, then unfavourable, coming from overseas and from developments in government spending and in domestic labour markets. Monetary growth in 1977/78 exceeded the target; the growth during the year estimated at the time, although high, understated the true position because of difficulties in correctly identifying seasonal movements. The problem of monetary control was intensified by the surge in government spending that occurred at the end of the year (a perverse response to the operation of cash limits) so that the true position

became clear only after the end of the financial year. Another factor was unexpectedly heavy inflows from abroad in 1977 until the exchange rate was allowed to float more freely.

**Earnings and prices** *are rising together.*

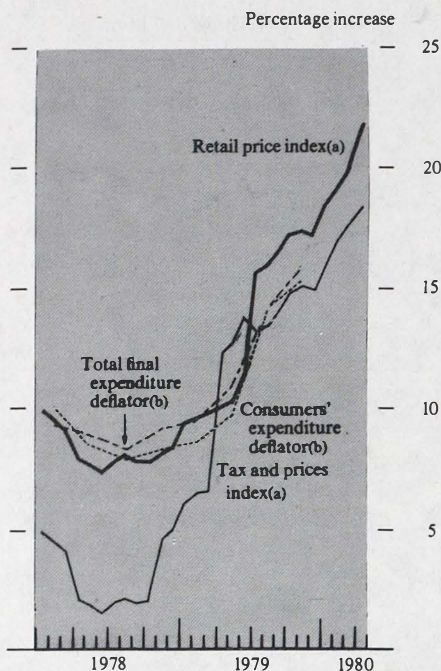



(a) The new series began in 1976.

There is an important—and difficult—question whether greater monetary restraint in 1977/78 would have affected the outcome of the 1978/79 pay round. This bears on the issue of how monetary policy is transmitted through the system to have an effect on inflation. A tighter monetary stance might have limited the upswing in demand, and produced a weaker labour market and a somewhat lower level of activity than actually occurred. But other factors were also relevant; fiscal policy moved to a less restrictive stance in 1978, and a major element in the upswing in demand was the high rate of earnings increases compared with prices. Tighter policies would have tended to raise interest rates and to bring forward the increase in the exchange rate—which, apart from a direct moderating effect on prices, might have stiffened resistance to pay demands. These possible effects are difficult to quantify.

From a year-on-year rate of price inflation of under 8% in mid-1978, the subsequent acceleration has, however, been very marked, with retail prices rising by nearly 22% over the year to May 1980. Much of the recent deterioration represents important special factors that can be readily identified: the sharp rise in oil prices through 1979 and the increase in VAT in the June 1979 Budget each contributed some three or four percentage points, and the rise in mortgage rates at the beginning of the year added a further one percentage point. But though much of the acceleration in retail prices may have been

*Changes in fiscal structure have had different effects on* **various measures of inflation.**




(a) Increase over the corresponding month in previous year.
(b) Increase over the corresponding quarter in previous year.

initiated by special factors, the underlying rate of inflation has accelerated dramatically; this is because the current rate of inflation appears to have been quickly anticipated in labour markets with the result that the outcome of the present wage round is expected to be at a similarly high rate. To some extent, the rise in nominal earnings must have reflected the rise in inflation. But the apparent absence of any lag of overall earnings behind prices in the current pay round suggests that pay rises may have been an independent source of price inflation. A relevant factor is that the increase in VAT was compensated by reduced income tax so that the net impact of the 1979 Budget on most households in 1979/80 was small. Retail or consumer prices series are misleading indicators when there are structural fiscal changes of this kind.

Bringing down inflation from its present high level is bound to involve transitional costs in terms of output and employment. But the size and duration of these depends on how quickly economic behaviour takes account of the monetary environment. The authorities have set a target in terms of monetary growth and not in terms of the ultimate objectives of policy—price stability, and high output and employment—since these are less directly within the authorities' control.

## Problems of monetary control

An upsurge in inflation, such as in 1979, inevitably complicated the task of monetary control and was likely to lead to rising nominal interest rates. After the June 1979 Budget, when the target for sterling $M_3$ was set at an annual rate of 7%–11%, the annual rise in retail prices, including the adjustment reflecting the VAT increase, was running at 15½%. Although the demand for sterling $M_3$ is not a relationship that can be estimated with any assurance in the United Kingdom (at least over short periods) there is a presumption that the demand for money will (other things being equal) rise roughly in proportion to an increase in the overall level of prices. Given further oil price rises, and the growing evidence that retail price increases were feeding through more generally into expectations of higher inflation, monetary growth continued at an uncomfortably rapid pace through the rest of 1979.

The problems posed by rising inflation presented themselves in a number of ways. One striking effect was the very rapid growth in the demand for bank credit. Over the financial year 1979/80, the growth of total sterling bank lending to the private sector averaged £750 million a month, compared with a monthly average of £500 million in the previous year. Much of this increase was the result of pressures on the company sector, which faced accelerating wage and raw material costs and a consequent need for additional working capital. With the new issues market rarely buoyant enough (especially since autumn 1979) to encourage companies to seek new equity, and with little or no readiness to seek long-term loan finance, short-term bank borrowing was the major channel through which companies were able to meet their cash needs. Corporate demand for bank credit was persistently high, despite the five percentage point rise in bank base rates between June and November last year. Over the six months to end-March 1980, bank lending to industrial and commercial companies rose, on a seasonally-adjusted basis, at an annual rate of 23%. An additional, less important, source of demand for bank credit last year came from consumers. Much of this was probably connected with

**Counterparts of the money supply(a)**

£ millions; *seasonally adjusted*

| Mid-month | Apr. 79– July 79 | July 79– Oct. 79 | Oct. 79– Jan. 80 | Jan. 80– Apr. 80 |
|---|---|---|---|---|
| Central government borrowing requirement | +2,588 | +2,805 | +2,342 | + 213 |
| Purchases (–) of central government debt by UK non-bank private sector | –2,686 | –1,017 | –3,085 | –1,507 |
| Other public sector(b) | + 128 | – 312 | + 265 | + 56 |
| Bank lending in sterling to: | | | | |
| UK private sector(c) | +1,946 | +2,341 | +2,253 | +2,459 |
| Overseas sector | – 17 | + 46 | + 270 | + 434 |
| **Domestic credit expansion** | **+1,959** | **+3,863** | **+2,045** | **+1,655** |
| External and foreign currency finance (increase –) | + 111 | –1,419 | – 722 | – 597 |
| Other | – 376 | – 326 | – 242 | – 360 |
| **Sterling $M_3$** | **+1,694** | **+2,118** | **+1,081** | **+ 698** |
| *Percentage change in sterling $M_3$* | *+3.3* | *+4.0* | *+2.0* | *+1.2* |

(a) Further details are shown in Table 11 in the statistical annex.
(b) Contribution to the public sector borrowing requirement by the rest of the public sector, less purchases of local authority debt and public corporation debt by the UK non-bank private sector.
(c) Including commercial bills held by the Issue Department of the Bank of England.

anticipatory purchases ahead of the 1979 Budget, and towards the end of the year the growth rate slackened.

Effects of rapid inflation were also seen in the gilt-edged market, where sentiment was affected by evidence of accelerating wage and price inflation. MLR was raised in the June 1979 Budget from 12% to 14%. The initial response in the gilt-edged market was favourable, and over £2 billion of central government debt was sold to the UK non-bank private sector in June and July. It soon became apparent, however, that both the central government borrowing requirement (CGBR) and bank lending to the private sector were remaining exceptionally high. These factors were offset in part in September and October by capital outflows—probably reflecting the first effects of the relaxation of exchange controls in June and July. Nevertheless, between June and October, recorded sterling $M_3$ rose at an annual rate of 15½%. In addition, significant amounts of bank acceptances—which the banks were induced by the operation of the corset to substitute on an increasing scale for conventional lending—were being taken up outside the banking system. In the six months from mid-June to mid-December, sterling acceptances by UK banks increased by £1.7 billion, or 43%, with about half of these being taken up outside the banking system (equivalent to about 1½% of sterling $M_3$ although not necessarily a substitute for it, because some may be held by overseas residents or replace holdings of public sector debt).

**Bank lending in sterling to private sector**

Percentages; *not seasonally adjusted*

| | Quarterly increase | | | Share of quarterly increase accounted for by: | |
|---|---|---|---|---|---|
| | **Total** | Industrial and commercial companies | Persons(a) | Industrial and commercial companies | Persons(a) |
| 1979 Q1 | 6.2 | 7.1 | 2.8 | 70.6 | 5.7 |
| Q2 | 6.8 | 5.8 | 9.7 | 53.0 | 17.8 |
| Q3 | 3.8 | 1.6 | 5.6 | 26.1 | 18.9 |
| Q4 | 4.8 | 3.1 | 3.8 | 39.6 | 10.5 |
| 1980 Q1 | 6.7 | 8.1 | 1.8 | 71.5 | 3.4 |

(a) Excluding lending to unincorporated businesses and lending for house purchase.

Short-term money-market interest rates began to rise during October. By November, they were already consistent with a rise in MLR of between one and a half and two percentage points to 15½%–16%, when the authorities, influenced also by a weakening gilt-edged market, responded by raising MLR to a record 17%. Measures were also taken to bring government borrowing into line with the Budget forecast.

The reaction of the gilt-edged market was again favourable and further substantial sales of debt restrained the growth of sterling $M_3$. From the turn of the year, public sector borrowing needs were low. (This was the first period during which VAT receipts at the higher rate were not offset by income tax rebates. There were also other special factors, notably the sale of BP shares which, though partly paid in November, led to further receipts in February; advance payments for oil to the British National Oil Corporation; and the effects of the partial unwinding of earlier delays in payment of telephone bills.) In addition, although bank lending showed no signs of slowing in the first quarter, external factors continued to exert a contractionary influence—no doubt still reflecting in part the abolition of exchange controls as well as the current account deficit. With this combination of factors working to reduce the rate of monetary expansion, the growth of sterling $M_3$ slackened significantly, being 6½% (at an annual rate) in the period from October to April and coming within the target range set for the period since June 1979. The movements of other aggregates confirmed the general tightening; $M_1$, sensitive to interest rates, fell, while wider indicators of private sector liquidity rose at much the same rate as sterling $M_3$ (although in the past they have tended to grow more rapidly). However, provisional estimates for May show a further sharp rise in sterling $M_3$, which would take it once more above the top of the target range.

**Growth of monetary aggregates at annual rates**

Per cent

| | $M_1$ | Sterling $M_3$ | Total $M_3$ |
|---|---|---|---|
| April 1979/April 1980 | 2.8 | 10.4 | 11.9 |
| June 1979/April 1980 | 4.7 | 10.0 | 10.7 |
| October 1979/April 1980 | −4.8 | 6.6 | 9.2 |

The restraint of monetary growth in a period when bank lending was very high resulted in a heavy drain of liquidity from the banking

system. In order to bring monetary growth back within the target, large sales of gilt-edged stocks remained necessary, despite the fact that the CGBR was temporarily low. With lending to the private sector growing faster than deposits, there was a reduction in short-term central government debt instruments held by banks. Since they form part of the banks' reserve requirements there were phases of sharp upward pressure on short-term money-market rates as the banks were obliged to bid for funds to hold as reserve assets. The pressures were particularly acute in the first quarter of 1980—the main tax-gathering season—when the CGBR in unadjusted terms was in substantial surplus. The origin of the problem, however, is the persistence of high bank lending and its apparent insensitivity in the short term to interest-rate changes. To prevent temporary increases in short-term interest rates, which would have taken them beyond the level necessary to contain monetary growth, the authorities intervened heavily and persistently. [1]All special deposits (equivalent to 2% of eligible liabilities) were released in January, and their recalls were repeatedly deferred and subsequently cancelled. In February, and again in April, the authorities bought significant quantities of non-reserve asset gilt-edged stocks from the banking system for later resale to inject liquidity. These arrangements were extended in May for a further month.

Three further points about the course of interest rates are noteworthy. First, the term structure has been indicating widespread expectations of a fall in interest rates over the next twelve months. At times, rates on twelve-month loans have been as much as two percentage points below those on three-month money, accentuated by the liquidity pressures noted above which exerted a distorting influence at the very short end of the market. Second, despite the rise in nominal interest rates, real interest rates may now be no higher than they were at the beginning of 1979. Third, while the rise in UK market interest rates in the summer and early autumn of 1979 occurred somewhat in advance of movements in other major centres, the rise in interest rates towards the end of 1979 became a general international phenomenon, with real interest rates in many other countries, including the United States, West Germany and Switzerland, appreciably higher than in the United Kingdom. Both nominal and real international interest rates rose further in the first three months of 1980, but in April and May they fell back sharply in North America, while remaining firm elsewhere (see section on international developments, below).

## The development of fiscal policy

The general effect of the June 1979 Budget appears to have been mildly deflationary in 1979/80 although, for most households, the main elements in the Budget—the increase in VAT and reductions in income tax—were broadly offsetting. The Budget forecast for the public sector borrowing requirement (PSBR) in 1979/80 was £8.3 billion, a figure that was in the event overshot by almost £1½ billion in spite of the bringing forward of payments of petroleum revenue tax. [2]Among the reasons for the higher PSBR outturn were local authority borrowing and public sector debt interest payments appreciably above forecast, reflecting the impact of higher than expected inflation on public sector costs and interest rates; an increase in the average lag between accruals and payments of VAT; and delays in payment of some telephone bills.

(1) For fuller details, see financial review, page 141.
(2) £700 million.

The balance of fiscal changes in the Budgets of June 1979 and March 1980 suggests a moderate overall tightening in policy stance, in particular as the full year effects of VAT at higher rates come through in 1980/81. On the expenditure side, total general government expenditure on goods and services in 1980/81 is expected to fall. The plans in the 1980 public expenditure White Paper pointed to a progressive reduction in the real level of public expenditure over the period to 1983/84. The PSBR is forecast at £8.5 billion for 1980/81, implying both a fall as a proportion of GDP and in absolute terms compared with the 1979/80 outturn, now put at £9.8 billion. Under the medium-term financial strategy, further reductions in the PSBR are envisaged.

This tightening in the fiscal stance in public sector accounting terms is, however, difficult to measure in economic terms, in particular given the distortions introduced by inflation and the shock to the system from the further sharp rise in oil prices.

**General government expenditure on goods and services(a)**
£ millions; 1975 prices

| | Annual averages | | | 1978/79 | 1979/80(b) |
|---|---|---|---|---|---|
| | 1970/71–1972/73 | 1973/74–1975/76 | 1976/77–1978/79 | | |
| Total general government expenditure on goods and services | 25,315 | 27,549 | 27,422 | 27,209 | 27,100 |
| *Percentage change over previous year* | *+2.6* | *+2.8* | *−1.3* | *+0.3* | *−0.4* |
| Gross domestic fixed-capital formation | 5,374 | 5,305 | 3,917 | 3,424 | 3,100 |
| *Percentage change over previous year* | *−0.1* | *−1.8* | *−12.1* | *−9.0* | *−9.5* |

(a) Excluding stockbuilding.
(b) Provisional and/or Bank estimates.

**The PSBR and sectoral financial balances**
Percentage of GNP at market prices

| | Annual averages | | | 1978/79 | 1979/80(a) |
|---|---|---|---|---|---|
| | 1970/71–1972/73 | 1973/74–1975/76 | 1976/77–1978/79 | | |
| Public sector borrowing requirement | −2.4 | −8.4 | −5.3 | −5.6 | −5.0 |
| Public sector financial balance | −1.3 | −6.5 | −4.8 | −4.8 | −3.3 |
| Company sector financial balance | 0.5 | −1.7 | −0.9 | −0.7 | −2.3 |
| Personal sector financial balance | 1.6 | 5.6 | 5.7 | 6.5 | 6.4 |
| Overseas sector financial balance | −0.8 | 2.2 | 0.4 | 0.1 | 0.8 |
| Residual error | −0.1 | 0.3 | −0.4 | −1.1 | −1.6 |
| Net payments of debt interest by the public sector(b) | 3.2 | 3.6 | 3.9 | 4.0 | 4.0 |

(a) Provisional and/or Bank estimates.
(b) Including receipts of dividends by the public sector.

The PSBR rose from 1%–2% of GNP in the early 1970s to nearly 10% in 1975/76, before declining to 5% in 1979/80. The public sector deficit—a better indicator of the fiscal position—shows a similar broad pattern. The counterparts to the change in the public sector position are shown in the table. The principal counterpart to the increased scale of public borrowing has been financial accumulation by the personal sector.

A basic problem in interpreting the figures is that sectoral surpluses and deficits are strongly influenced by inflation. The pattern would look quite different on an 'inflation-adjusted' basis, that is, after allowing for the effect of inflation in eroding the real value of net monetary assets.[1] In the case of the public sector—a large net debtor—it is notable that net debt interest payments have been rising and are now equivalent to 4% of GNP. As an approximation to the inflation-adjusted figures[2] net debt interest payments can be deducted when looking at the public sector position. On this basis,

(1) See the Bank's Discussion Paper No. 6 *'Real' national saving and its sectoral composition* by C. T. Taylor and A. R. Threadgold, and also the supplementary note, page 196.
(2) Putting the figures onto a 'realisations' rather than, as in the supplementary note, an accruals basis.

the public sector was in deficit from 1973/74 to 1978/79 and has since moved into surplus.

The interactions between the public sector balance and the financial position of other sectors are affected by external shocks. Part of the steep rise in public borrowing in the mid-1970s reflected the position of the economy following the impact of the exceptional rise in oil prices in 1973–74. The recent oil price rises have complex effects on financial flows for an economy, like the United Kingdom, which is approaching self-sufficiency in energy. The rise in price affects the non-oil private sector in much the same way as an increase in indirect tax. In the first instance, however, the additional revenues accrue to oil companies, which build up funds in the United Kingdom or pass them abroad. Eventually, the major proportion is paid over to the Exchequer as royalties or tax—but with a lag which depends both on the normal delay before taxes are paid as well as on the rate at which allowances against tax are used up.[1] Thus, the general price-increasing and real expenditure-reducing effects of the oil price rise have been occurring before most of the benefits to public revenues are felt. The oil price rise experienced in 1979 is a major contributory factor to the expected recession in both the United Kingdom and most of the world economy this year and next.

But though these implications of inflation and of the oil price rise have considerable relevance for appraisal of the stance of fiscal policy, a prime concern is that the balance of fiscal action should be consistent with, and supportive of, monetary policies designed to bring down inflation. In assessing the likely monetary implications of public sector borrowing, the public sector deficit, whether or not inflation-adjusted, has less relevance than the nominal PSBR, which is an essentially financial magnitude. The size of the nominal PSBR can—as in 1979/80—diverge substantially from the public sector deficit. Given that the PSBR is one of the major counterparts to monetary expansion, judgment is required both on the fiscal stance taken in isolation and on its compatability with the monetary objective.

The proximate concern is, of course, about the level of interest rates which may be necessary if any given PSBR is to be financed without inducing excessive monetary expansion. That the connexion between changes in the money supply and changes in some of its counterparts is not straightforward is demonstrated in Table 11.3 in the statistical annex: the monetary implications of a change in the PSBR depend on the circumstances that give rise to it. There are, however, specific reasons for concern about the monetary implications of high public sector borrowing. These are associated in particular with the importance of expectations in markets about the future course of the nominal PSBR and the risk of disturbance in the gilt-edged market, and thus in the pace of monetary growth, if required sales of gilt-edged stock become very large in relation to the cash flow of the institutions which are the principal buyers of such debt.

(1) Both royalties and petroleum revenue tax (PRT) are payable two months after the six-month period to which they relate. In theory the marginal tax rate for an increase in the crude oil price now stands at about 87%. But as a result of allowances designed to limit tax liability early in the life of producing fields, only a small number of companies operating in the North Sea are currently paying PRT or corporation tax on these activities. Accordingly, the aggregate short-run marginal tax rate is currently much less than the long-run rate.

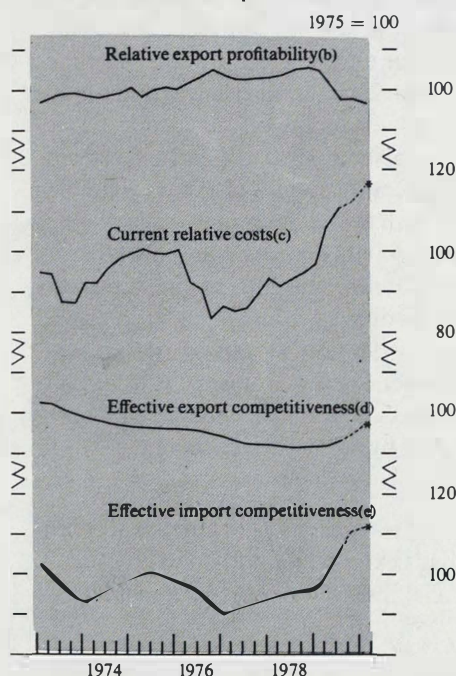
**Balance of payments: current account**

£ millions; *seasonally adjusted*

| | 1979 | | | | 1980 |
|---|---|---|---|---|---|
| | Year | Q2 | Q3 | Q4 | Q1 |
| Visible balance | −3,312 | −486 | −493 | −745 | −723 |
| *of which:* | | | | | |
| *Oil balance* | − 779 | −229 | −158 | −157 | −126 |
| *SNAPS balance*(a) | − 83 | − 31 | − 56 | + 74 | − 23 |
| *Underlying non-oil balance* | −2,450 | −226 | −279 | −662 | −574 |
| Invisible balance | + 993 | +129 | +410 | + 34 | +306 |
| **Current balance** | **−2,319** | **−357** | **− 83** | **−711** | **−417** |

(a) Ships, North Sea production installations, aircraft and precious stones.

**Competitiveness** *has continued to deteriorate in recent quarters.*[(a)]




* Bank estimates for fourth quarter 1979 and first quarter 1980.

(a) Except for relative export profitability, a downward movement in a series indicates an improvement in competitiveness.

(b) Ratioof UK export prices of manufactures (excluding erratic items) to prices of manufacturing output.

(c) Ratio of UK normalised unit labour costs to those of competitor countries: IMF series.

(d) A weighted average of current and past relative costs. the weights being derived from coefficients in an equation explaining the volume of manufactured exports.

(e) A weighted average of current and past relative costs and prices, the weights being derived from coefficients in an equation explaining the volume of imports of finished manufactures.

## A strong pound and weakening competitiveness

In spite of a current account deficit in 1979 of £2.3 billion and a continuing monthly deficit of about £150 million in the early part of 1980, sterling has remained strong, in contrast to earlier expectations. At the time of the negotiations leading up to the institution of the European Monetary System (EMS) in March 1979, a common concern was that the relatively high rate of inflation in the United Kingdom would lead to a depreciation of sterling. In fact, sterling appreciated by some 10% in effective rate terms during 1979 and by 4½% in terms of the ECU basket.

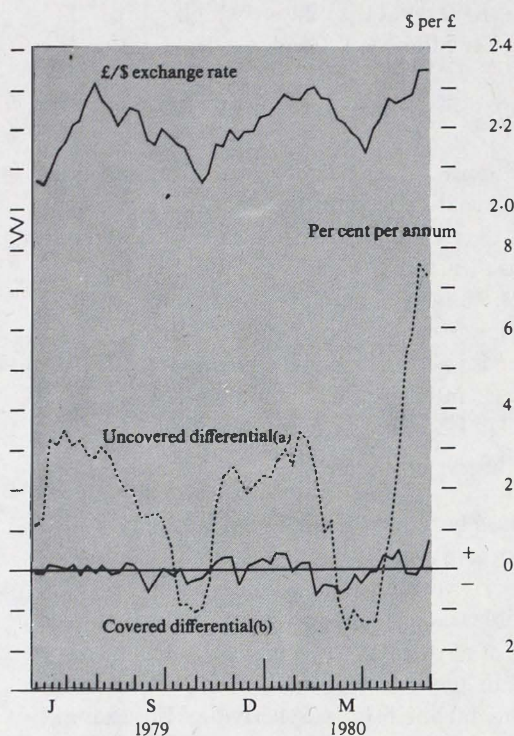
High inflation and the appreciating exchange rate were associated with a serious fall in international competitiveness. The worsening is particularly marked in terms of relative normalised unit labour costs; according to this measure, competitiveness deteriorated by almost 20% during 1979 and by about 35% from the fourth quarter of 1976. A major question is how far the recent appreciation of sterling is to be explained by the impact of North Sea oil, as compared with interest-rate differentials which, in particular after the fall in US interest rates in April and May, became exceptionally favourable to London.

North Sea oil production has been building up steadily since 1975 and, by 1979, net imports of crude oil were only about 20 million tonnes. Self-sufficiency is expected in the second half of this year. The impact on the visible trade balance has been marked; its overall impact on the balance of payments, however, depends also on payments of interest and dividends abroad, as well as other flows relating to UK Continental Shelf (UKCS) activities. For example, in 1979 the visible oil balance improved by £1¼ billion but profits due abroad from UKCS activities increased by some £¾ billion.

The main exchange rate effects of increasing North Sea production, however, probably derive less from the mechanical impact of the current account than from capital flows. The United Kingdom, as a virtually self-sufficient oil producer, was relatively insulated from the direct effect on the current account of the sharp rises in oil prices and, with continuing uncertainties in the Middle East, thought likely to be better insulated than others from any further upset to the world oil market. Other OECD countries experienced a substantial increase in their oil deficits and a consequent deterioration in 1979 of some $45 billion on current account. Had the desired distribution of capital flows from OPEC countries matched the pattern of current account deficits induced by higher oil prices there would, of course, have been no effect on the net relative demand for different currencies, and no effect on exchange rates. However, part of the OPEC surplus was invested in sterling, and this, together with a general shift in the composition of investors' portfolios into sterling, gave rise to a significant excess demand for the currency at existing exchange rates.

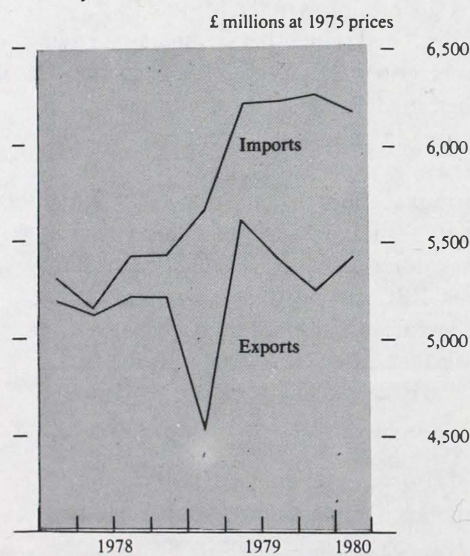
Capital flows were also affected by other influences. Domestic interest rates moved sharply upwards on two occasions last year, on 12 June and 15 November, accompanied by an appreciation of sterling against the dollar; as US rates subsequently moved up, closing the differential, sterling weakened in response but strengthened again as US rates fell sharply after the middle of April. The abolition of exchange controls probably led to capital outflows from the private sector of the order of £2 billion in the second half of last year (see December 1979 and March issues of the *Bulletin*) and there was a significant portfolio investment

*The (uncovered)* **interest-rate differential** *in favour of sterling widened in April and May; and* **sterling rose sharply** *against the US dollar.*




(a) Three-month £ inter-bank rate *less* three-month euro-dollar rate.
(b) Adjusted for the cost of forward cover.

**Underlying non-oil export volumes** *recovered in the first quarter of 1980, while* **import volumes** *remained broadly stable.*




outflow in the first quarter of 1980, thereby reducing the upward pressure on the rate.

The interest differential in favour of sterling may have recently been the predominant immediate influence on the exchange rate, while at times in 1979 the uncertainties associated with oil were particularly important. These factors made it possible for the exchange rate to appreciate though the current account remained in deficit.

With the oil current account little changed overall, there was a worsening of non-oil trade, probably resulting from a dramatic deterioration in competitiveness. It has been noted in previous issues of the *Bulletin* that the lags between changes in competitiveness and trade flows appear, in general, to be shorter on the import side. In 1979, the bulk of the deterioration in the balance of resources took the form of increased import penetration rather than reduced export market share. It was largely because of the growth of imports that the rise in GDP in 1979 was only some $1\frac{1}{2}\%$. This current account deficit has continued into 1980, though with indications of favourable movement when allowance is made for recent distortions caused by trade in silver and the steel dispute. The volume of exports—excluding oil and erratic items—recovered in the first quarter of 1980 to about the level of the third quarter of 1979. The general pattern of export volume in recent quarters has been flat, with the adverse impact of worsening effective competitiveness being roughly offset by the effects of an increase in world trade. The volume of imports, on the same basis, fell back in the first four months of 1980 from the high level reached in the second quarter of 1979 and sustained in the rest of the year. Effective import competitiveness worsened substantially last year, but has deteriorated less rapidly in recent months, and its effect on imports has been offset by a general weakening in domestic demand.

A consequence of the movements on capital and current account was that the United Kingdom's external liquidity position, as measured by the ratio of official reserves to short-term liabilities, continued to deteriorate.

The underlying deficit to be financed in 1979 was about £$5\frac{1}{4}$ billion, as a result of the current account deficit of £$2\frac{1}{4}$ billion, official debt repayments of about £1 billion and outflows of about £2 billion as a result of the abolition of exchange controls. This deficit was more than covered by other net inflows, mainly short-term, thus allowing the reserves to increase by £1 billion. This pattern of external flows—an underlying deficit largely financed by short-term capital inflows—may well continue. With the loss in competitiveness experienced recently, the non-oil current account may weaken; and there is the prospect of continuing outflows as a result of the removal of exchange controls. Any deterioration in the non-oil current account deficit will, however, be contained by the move to recession in the United Kingdom, which is expected to be rather deeper than in most other industrialised countries.

## Pay settlements still high

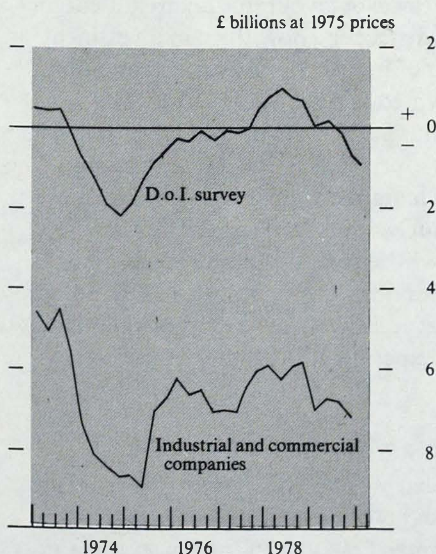
The present stance of policy is most directly counter-inflationary through its effect on the exchange rate and thus on the domestic price level. In the longer run, the progressive reduction of inflation will turn on the subsequent moderation in the rate of increase in earnings and unit labour costs. In the private sector this

moderation is encouraged, first, through the impact on wage claims of a smaller increase in prices (as the result of the appreciation of sterling), and second, via the pressure on companies and employers generally, and thus on their ability to pay.

There are clearly lags between the implementation of policy and the response of wages. During the 1979/80 wage round there has been little evidence of a moderation in wage settlements, even in manufacturing which is more exposed to the competitive pressures generated by the faster growth of costs (than in competitor countries) and an appreciating exchange rate. Average earnings in the manufacturing sector in March were 16% higher than a year earlier; but after allowance for the steel strike the increase was about 19½%, compared with about 16% towards the end of the 1978/79 wage round. Nevertheless, to judge from some important examples of restraint within the manufacturing sector, settlements appear to have been influenced to some extent by the financial position and prospects of the company. Provisions for reduced manning, or other means of raising productivity, are included in perhaps a third of settlements in private manufacturing; a number of settlements, however, do include agreements on the phased introduction of shorter working hours, which could have the opposite effect on unit costs.

In the services sector—particularly in financial services—and in the public sector, average earnings have tended to rise faster than in manufacturing. In part, this represents an unwinding of relativities which had been compressed by a succession of incomes policies. Thus, in the non-trading public sector, this year's settlements have been running at about one or two percentage points below those in manufacturing; but unwinding, in the form of comparability awards made largely by the Clegg Commission, appears to have added, on average, about ten percentage points to settlements. In contrast, the trading public sector has been achieving settlements higher than in manufacturing—reflecting perhaps the strength of the energy-producing sector. In total, average earnings for the whole economy in November to March were running about 20% or so higher than a year earlier. This rate may have increased further in April because of the delayed implementation of some comparability awards, some tendency for the public sector and the service sector to settle late in the round, and the end of the steel strike. Even so, there is little indication of any acceleration in settlements, and the annual increase may fall back towards the end of the wage round: the pattern of settlements this round has been fairly normal whereas in 1978/79 agreements on settlements tended to be delayed. (For example, the July 1979 average earnings index was artificially high on account of substantial back-pay to teachers and the police.)

**Company liquidity** *continues to deteriorate.*(a)




(a) Real net current assets (deflated by the TFE deflator).

## Companies under increasing financial pressure . . .

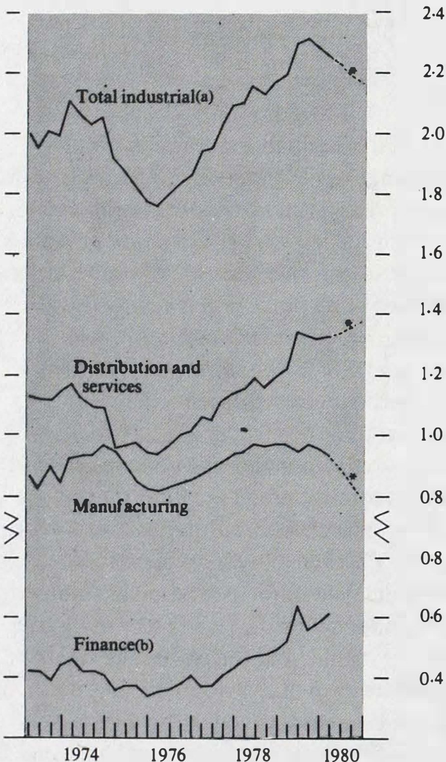
The combination of powerful cost inflation, tight monetary and fiscal policies and deteriorating competitiveness has put severe pressure on company profits, and thus on cash flow and liquidity. Previous issues of the *Bulletin* have drawn attention to the depressed level of the real profitability of industrial and commercial companies, and the supplementary note on page 191 analyses the latest information in detail. In 1979, real profitability declined sharply, after three years in which there had been some modest recovery from what were already low levels. The main factors in the decline were the resurgence of cost pressures, particularly from oil prices, and worsening trade competitiveness.

**Industrial and commercial companies: financial position**

| | Financial surplus + / deficit – £ billions | Non-North Sea financial surplus + /deficit –(a) £ billions | As percentage of current price GDP |
|---|---|---|---|
| 1973 | –0.2 | — | — |
| 1974 | –3.4 | –2.8 | –3.8 |
| 1975 | — | 1.3 | 1.4 |
| 1976 | –0.2 | 1.5 | 1.4 |
| 1977 | –1.0 | –0.1 | –0.1 |
| 1978 | 0.6 | 1.1 | 0.8 |
| 1979 | –4.5 | –4.5 | –2.8 |

(a) Bank estimate.

*Overall,* **industrial investment** *has started to decline.*




• Forecasts based on the May 1980 Department of Industry survey of investment intentions. A forecast for the finance sub-sector is not published.

(a) Manufacturing, and distribution and service industries.
(b) Includes leasing.

**Investment plans for 1980**

Department of Industry investment intentions surveys

| | 1979 | | 1980 | |
|---|---|---|---|---|
| Published in: | June | October | January | May |
| Manufacturing | A slight fall | A fall, possibly by as much as 7% | A fall of 6%–10% | A fall of 8%–12% |
| Distribution and services | A rise of 5%–7% | A further, small increase | A further increase of not more than 5% | A rise of not more than 5% |

A further important contribution to the deterioration in the financial position of companies was their relatively slow adjustment of capital spending and dividend payments to the sudden and largely unexpected pressure on company profits. Spending on fixed investment and stocks, which had risen sharply in the three years following the squeeze in 1974–75, increased by about 25% (in nominal terms) in 1979. And company dividends, which were also on a rising trend, were boosted by the abolition of dividend controls in July, and increased by over 45% last year.

As a consequence, the company sector moved into substantial deficit in 1979—£4½ billion, excluding the contribution from North Sea oil—compared with a surplus of over £1 billion in the previous year. This was the highest recorded deficit in nominal terms, but the real position was worse in 1974. Nevertheless, it is likely that the deficit has been understated because part of the residual error in the national accounts may be due to unrecorded expenditure by the company sector. The financial accounts, incorporating the unidentified acquisition of financial assets of £2 billion in 1979, suggest a deficit of about £6½ billion.

As the deficit widened, companies turned increasingly to bank finance (£5 billion in 1979). In spite of this, capital gearing at replacement cost was unchanged during the year, remaining very low and at about half the level reached in 1970. This was because the rise in borrowing was matched by the higher current valuation of capital employed arising from accelerating inflation. Income gearing, on the other hand, was pushed up by the increase in interest rates to its highest level since 1975.

The company sector's financial position is likely to have deteriorated further since the beginning of this year with the continuing rise in costs and with worsening competitiveness. The deterioration may have been greatest in the manufacturing sector. There are now signs that companies are reacting by cutting back on capital spending: between October 1979 and March 1980, manufacturing investment was almost 2% lower than in the previous six months.

Spending by the distribution and service industries has also flattened out since the second quarter of last year, although this may partly reflect the withdrawal of favourable tax treatment for leased vehicles. Stronger evidence for a downturn in investment comes from the Department of Industry's investment intentions surveys. The May report pointed to a drop of 8%–12% in manufacturing investment this year—a further downward revision from the 6%–10% which was projected in the January survey. The outlook for 1981, inevitably tentative at this stage, is that investment may fall by as much as in 1980. The contraction in manufacturing investment will be partially offset by leasing, much of which is classified under service sector investment. Distribution and services spending, however, is likely to be less buoyant than it has been, with little change expected in 1981 after a rise of not more than 5% this year.

There are also signs of a downturn in stockbuilding. Manufacturers' stocks fell sharply in both the fourth quarter, and the first quarter, and so brought to an end thirteen successive quarters of stockbuilding. In the first quarter there was also a cutback in inventories held by wholesalers and retailers. The latest

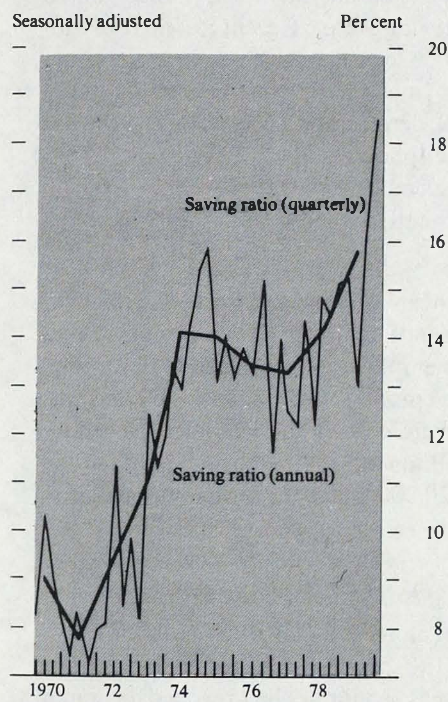
**Stockbuilding**

£ millions 1975 prices; *seasonally adjusted*

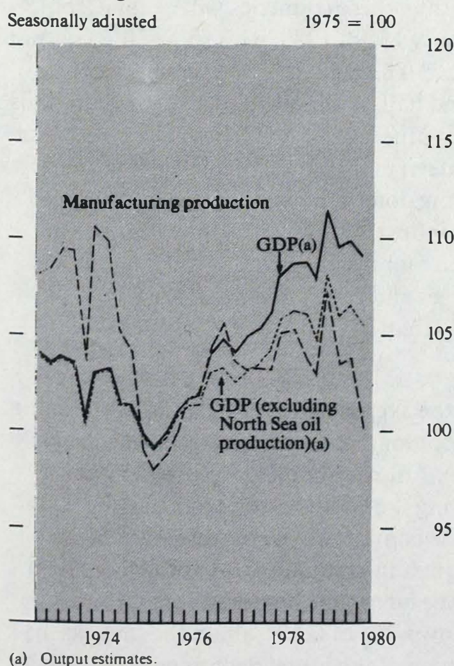
| | 1976 | 1977 | 1978 | 1979 | 1980 Q1 |
|---|---|---|---|---|---|
| Manufacturing | 350 | 510 | 545 | 270 | −370 |
| Distribution | 350 | 460 | 350 | 580 | −200 |
| Other industries | −245 | 225 | −155 | 1,020 | .. |
| **Total** | **455** | **1,195** | **740** | **1,870** | .. |

.. not available.

*The personal* **saving ratio** *reaches a new peak.*




**Output** *begins to weaken.*




(a) Output estimates.

figures must be interpreted with particular care, however, because of the impact of the steel strike. The May CBI survey of business opinion suggests significant destocking this year, in response to financial pressures on manufacturers.

## . . . with slackening demand, output and employment

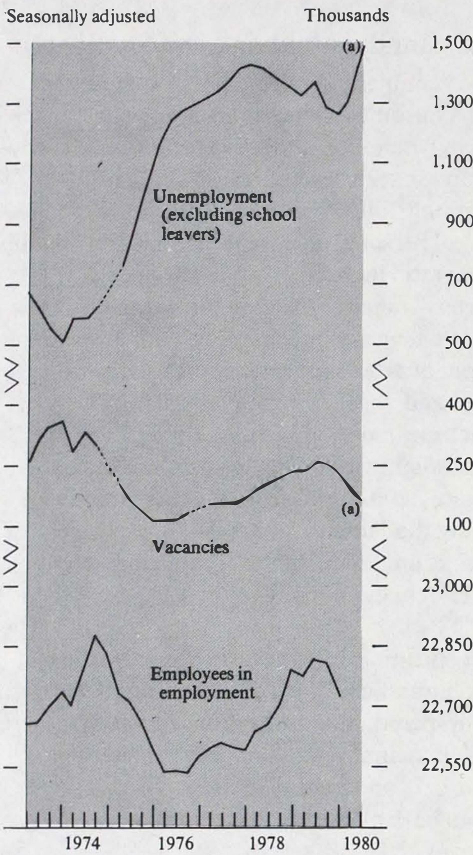
The emerging weakness in company spending has to some extent been offset by a revival in consumer demand resulting in part from tax rebates. Over 1979 as a whole, consumers' expenditure grew by 4%,with much of the increase seen in retail sales. The continued growth in consumer spending, following the 5½% increase in 1978, reflected the 6% rise in real personal disposable incomes during the year. However, the saving ratio increased—to reach a peak of 18½% in the fourth quarter—in part reflecting the normal lag before spending adjusts to changes in income. The path in spending over 1979 was erratic from quarter to quarter because of responses to the Budget tax changes and, to a lesser extent, strikes. This makes it difficult to form a clear view of the underlying trend, but there seems to have been a slight weakening in spending since the first half of last year despite the stimulus from the exceptional offers from retailers during the January 1980 sales. The outlook for the remainder of this year is uncertain, but as real incomes come under pressure, consumer demand is likely to weaken.

The growth in consumer spending over the last two years was met to only a small extent by domestic producers, even though there appears to have been widespread underutilisation of capacity; there was thus a sharp increase in manufactured imports, excluding the erratic items, of 13½% in 1978 and almost 18% last year. A large part of this movement can be explained by the deterioration in competitiveness (see above).

Total final expenditure increased by about £4.2 billion (in 1975 prices) between 1978 and 1979, and imports by £3.5 billion, leaving little growth in output. Problems of interpretation are aggravated by the large residual error between the income and expenditure estimates of GDP. The output measure—thought to be the most reliable indicator of short-term movements—was some 1½% higher than in 1978, but roughly half of this was due to the 44% increase in North Sea oil and gas production. As with consumer spending, the pattern of output from quarter to quarter was highly erratic, largely because of the impact of industrial disputes. More recently, the picture has been complicated by the steel strike in the first quarter, but the signs are that the slackening in demand has begun to affect output. GDP (output), excluding oil, fell by almost 1% between the fourth and first quarters, with a 3% drop in the manufacturing sector. Much of this must have been due to the direct and indirect effects of the steel strike, but a downturn is clearly visible in some industries within the manufacturing sector. Output in the textile, leather and clothing industries, for example, has fallen by 10% since last summer.

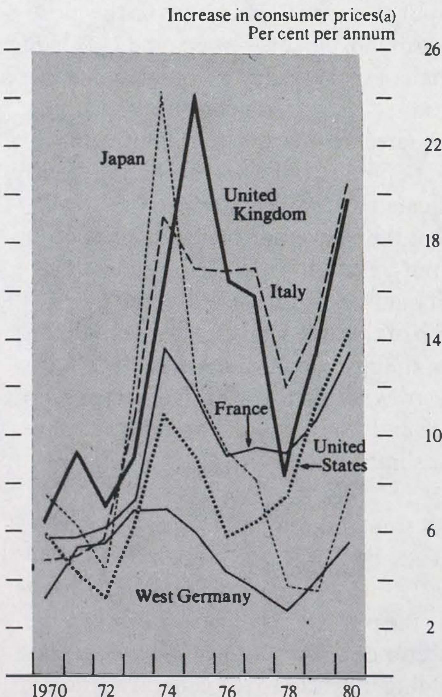
In other sectors, notably housing, there are more definite signs of a downturn in activity. Total housing starts were only 220,000 in 1979—the lowest for nearly thirty years—and may be still lower in 1980. One major factor is the post-war trend away from public sector building to private sector development which has increased the vulnerability of the building industry to the general economic climate. In the private sector, housebuilding is likely to be weak this year because of the continuing difficulties which

**Vacancies** *fall while* **unemployment** *rises.*




(a) The last plot is for May rather than end-quarter.

**Inflation differentials** *between the major countries are now almost as wide as in 1974–75.*




(a) Annual averages except for 1980, where the figures refer to the first four months compared with the same period a year earlier.

building societies face in maintaining the flow of mortgage finance. Delays in obtaining funds, and therefore in completing sales, mean that builders are left with property for longer periods. With interest rates at current levels, many builders have been forced to delay starts in order to avoid an excessive rise in stocks of unsold dwellings. A further drop in public sector housebuilding also seems likely with the tightening in the financial position of local authorities.

The weakening in activity is most clearly seen in the labour market; employment levelled off in the middle of last year after three years of virtually uninterrupted growth and has since fallen. Many of the private service industries, which were responsible for the earlier growth, continued to expand, but this was offset by a reduction in civil service and local authority employment and the substantial loss of jobs in the manufacturing sector. Recent losses from the manufacturing sector must be seen against a longer-term trend away from industrial employment, dating from the mid-1960s. But, by the summer of 1979, deteriorating prospects and the tightening financial squeeze appear to have induced a more rapid shakeout of labour. In the six months to end-March, manufacturing employment fell by 188,000, or by $2\frac{1}{2}\%$ of the sector's work-force.

The first evidence of the worsening prospects for employment was a sustained fall in the number of unfilled vacancies from the peak last June. By September, unemployment appeared to be levelling out after more than eighteen months of slow but steady decline. Subsequent increases have raised the number of unemployed to a new post-war peak of $1\frac{1}{2}$ million in May, just over 6% of the work-force. This is some 220,000 above the low point reached in September.

## Rising prices and recession in other countries

The United Kingdom is not alone in facing a combination of inflation and recession. By the spring of this year, consumer price inflation in the major overseas economies had reached an annual rate of over 14% (latest three months on previous three), more than double the rate at the end of 1978. At the same time it is widely expected that growth in these countries will decline from $3\frac{3}{4}\%$ last year to perhaps only 1% in 1980, with some fall in output during the course of the year. The United States is now clearly in recession, and by the second half of the year slower growth, or falls in output, are likely in most other major countries. The increase in oil prices over the last eighteen months has intensified inflationary pressures, and, by depressing domestic real incomes, has reduced demand. In most overseas industrial countries, the faster rise in prices over the last eighteen months has not induced a significant acceleration in wages. Wages and earnings abroad are rising, on average, much more slowly than in the United Kingdom.

### The rise in oil prices

By the beginning of June, the average price of OPEC oil (including an allowance for sales at spot market and at spot-related prices) had reached $31 per barrel. A further increase, of up to $2 per barrel, seems likely following the OPEC meeting in Algiers. This would represent an increase of over $20 per barrel since the end of 1978, more than twice as great in nominal terms as the increase in 1973–74. The increase in the oil import bill for the OECD area, however, amounts to just over 2% of GNP, about the same as in 1973–74. This is an indication of the initial deflationary impact

on the OECD economies, which will be intensified by second-round multiplier effects, but reduced by higher spending by OPEC from increased revenues. The future course of the price of oil remains very uncertain and presents major risks to the outlook for the world economy as a whole. In the immediate future, the likely decline in world economic activity (particularly in the United States) will tend to reduce demand for energy. Oil stocks in consuming countries are now very high and demand for OPEC oil is likely to fall. This might suggest a small fall in the real oil price, and, indeed, oil prices in spot markets have tended to fall since the end of 1979. Other factors, however, may work in the opposite direction. Non-OPEC supplies of oil have expanded rapidly in recent years, but will now grow more slowly, as output from the North Sea and in Mexico begins to level off. And a number of OPEC countries are planning to cut production, so that world oil supplies in total may fall. It is against this background that official OPEC oil prices have continued to rise this year, despite the growing signs of recession.

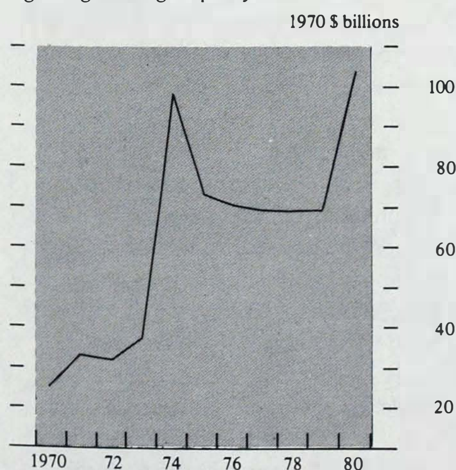
After 1974, the OPEC surplus declined rapidly, not only because of the fall in the real price of oil, but because OPEC import volume rose very substantially (see the article on page 154). It is unlikely that this hectic increase in the rate of OPEC absorption will be repeated. Import demand had already tailed off in 1978–79, (partly, but not wholly, on account of events in Iran) while social and political pressures, and fears of overheating, are likely to restrain the pace of development in OPEC economies. The growth projected for 1980 (around 20%), will be high by international standards, but will do little more than make up for the decline experienced last year. Projections both of oil revenues and of imports suggest that the OPEC surplus will be more persistent this time than it was after 1973–74; but great uncertainties surround any forecast.

**OPEC surpluses force deficits elsewhere**

World current payments imbalances increased only slightly in real terms in 1979, when the return of OPEC countries to substantial surplus on current account was largely offset by OECD countries with traditional surpluses moving into heavy deficit. However, imbalances are now increasing dramatically.

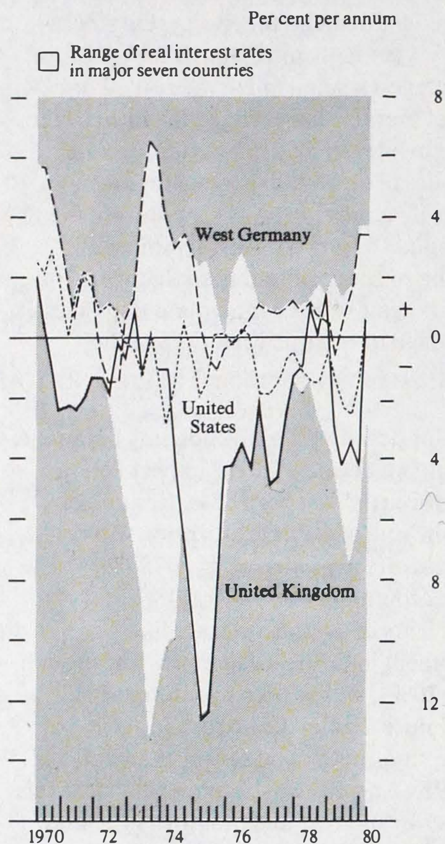
So far, the pattern of current account deficits which has emerged as the counterpart to the OPEC surplus seems likely to impose smaller strains than after 1973. A substantial share of the deficit is now being borne by the major industrial economies (particularly Japan and West Germany, which accumulated large surpluses in 1974-78). The share borne by smaller OECD members and by non-oil developing countries is much less than last time, although in nominal terms their deficits in 1980 may far exceed those registered in 1974. Within the group of major economies, there are likely to be substantial shifts in balances, as there were in the earlier years, as relative cyclical positions change and movements in competitiveness take effect. The US recession has begun earlier, and may well be deeper, than that expected for other major countries. There have been sizable changes in competitiveness over the past year, principally associated with the decline in the yen, but also brought about by differing inflation rates among the countries with the relatively more fixed exchange rates of the EMS. Nevertheless, the major countries as a group may have to accept a higher proportion of the deficit than in 1979 because many of the

**International payments imbalances**
*eased modestly after 1974 but are now again growing rapidly.*[(a)]



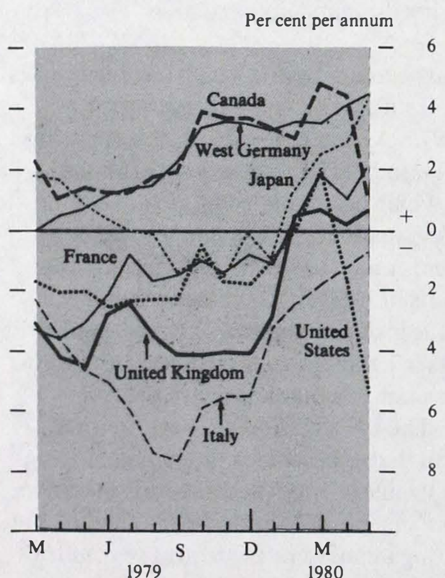

(a) Absolute sum of world current account surpluses and deficits, deflated by an index of manufactured export prices. Bank estimates for 1979 and forecasts for 1980.

**Real interest rates** *in the major countries have remained much closer together during the recent inflationary surge than in 1973–75.*[(a)]




(a) Quarterly averages of nominal short-term interest rates deflated by the 'expected' annual rate of inflation as proxied by the change in consumer prices in the preceding and subsequent half years (including forecasts for the latest observations).

*Since March,* **real interest rates** *have fallen sharply in North America but have remained firm elsewhere.*[(a)]




(a) End-month nominal three-month interest rates deflated by the 'expected' annual rate of inflation as proxied by the change in consumer prices in the preceding and subsequent half years (including forecasts for the latest observations).

smaller industrial and developing countries are unable, or unwilling, to accept a greater deterioration, given the cumulative effects on their balance sheets of the deficits of recent years.

Before the early 1970s, current account imbalances in the world economy were largely offset by compensating flows of direct investment and concessional government loans. Such structural outflows from surplus countries proved wholly inadequate to finance the imbalances of the 1970s, which have increasingly been recycled through the rapidly growing international capital markets. In consequence, the accumulated current account deficits of the developing countries and most industrial countries have corresponded quite closely with their increasing financial indebtedness since 1973. In real terms, the increase in indebtedness has been less pronounced. For example, it is estimated that the indebtedness of the non-oil developing countries (net of their holdings of financial assets) more than trebled between 1973 and 1978 to nearly $140 billion; world prices doubled over the same period, so that real net indebtedness rose by two thirds. Even in real terms, however, net indebtedness grew much faster than real exports (which rose by about one third over the same period). Both the developing countries and the smaller industrial economies are likely to suffer balance of payments constraints for as long as the OPEC surplus persists, either because of limits imposed on their borrowing by lending institutions (or their supervisory authorities) or because of the financing problems perceived by the countries themselves.

**Cautious economic policies abroad**

Despite growing signs of recession, the reduction of inflation remains the prime policy target in virtually every industrial country. As inflation rose in 1979, there was a strong increase in interest rates in all the major overseas countries. For the most part, this reflected attempts to contain domestic inflation but also, perhaps, the fact that a large number of countries now want a firm (or rising) exchange rate as part of their counter-inflation strategy. By March of this year, real interest rates in all the major overseas countries (apart from Italy) were positive, within a fairly narrow range, even though inflation differentials have widened over the past year. From February, however, output in the United States had begun to fall, and, following the announcement of credit controls in March, demand for credit fell sharply. The growth in monetary aggregates slowed further to bring them to, or below, the bottom of the target ranges, and interest rates were allowed to drop substantially. Since inflationary expectations are unlikely to have fallen so precipitously, real interest rates became negative.

Although a divergence has emerged between real US rates and those of other countries, the range has not so far approached that of 1973–75, when the policies which were adopted varied more between countries. At that time, some put more emphasis than at present on maintaining output and activity, and this was also reflected in divergent fiscal policies. On this occasion, virtually all governments are unwilling to adopt expansionary measures; budget deficits are now generally larger than before the last recession, and governments are concerned to limit the size of any increase even if activity weakens. The United States Government, in particular, has been planning a small surplus in the Federal Budget in the next fiscal year, implying a substantial surplus on a 'full employment' basis.

**Average earnings in manufacturing in six major overseas economies**

Percentage changes on year earlier

| | 1978 | 1979 | | | | 1980 |
|---|---|---|---|---|---|---|
| | Q4 | Q1 | Q2 | Q3 | Q4 | Q1(a) |
| United States | 9.1 | 8.9 | 8.7 | 8.6 | 7.6 | 7.3 |
| Canada | 6.9 | 7.6 | 9.0 | 8.8 | 9.4 | 8.7 |
| Japan | 5.6 | 5.7 | 7.1 | 8.4 | 8.0 | 8.4 |
| West Germany(b) | 5.7 | 4.9 | 4.9 | 4.8 | 4.7 | 4.7 |
| France(b) | 13.4 | 12.9 | 13.4 | 12.3 | 13.1 | 13.8 |
| Italy(b) | 14.9 | 15.7 | 17.0 | 20.4 | 22.2 | 22.6 |
| Average(c) | 8.5 | 8.4 | 8.8 | 9.2 | 8.8 | 8.8 |

(a) Estimates.
(b) Wage rates.
(c) GNP-weighted.

**Inflation and sectoral balances within the major economies**

It was suggested above that the major countries will take a larger share of a more persistent deficit than after the last major oil price rise. This implies, within these countries, larger financial deficits or smaller surpluses for the various domestic sectors. Public sector deficits, it was also suggested, would not be allowed to become large, and this in turn implies worse financial balances for the private sector. A major question for the future is whether private sectors will accept this deterioration, or will attempt to avoid it, either by forcing up wages and prices or by cutting expenditures.

Developments so far, within both household and business sectors, provide some grounds for supposing that the private sector may be in a position to accept a deterioration in its financial balance without an intense reaction. Employees in most overseas countries have made little attempt to recover the losses in real wages implied by higher oil and other commodity prices, and wages have generally not shown any significant acceleration. The main exception remains Italy, where wage indexation is widespread. To judge from wage settlements early this year, the 1980 wage round will again be moderate in most overseas countries.

The slower growth, or fall, in real personal incomes has not so far been fully reflected in consumption, because saving ratios have fallen. Moderation in wage settlements has helped to maintain business profits; and this may be one reason why business investment plans have not (according to surveys) been pruned in recent months. Surveys also suggest that stocks are not generally deemed excessive, so that massive destocking is less likely. In the coming months, saving ratios may well rise, so that consumption could fall in the second half of this year; but, unless there is a further major upsurge in oil or other commodity prices, inflation should fall, and even with continued wage moderation real incomes could recover, allowing resumed growth in consumption next year. With wage moderation, but the prospect of perhaps only a temporary dip in consumption, and with interest rates perhaps declining as inflation falls, businesses may feel able to continue spending on fixed assets and stocks even if this entails increased recourse to outside finance.

Such an outturn would be very different from that following the last major oil price increase. Personal income then rose as a share of national income, and profits declined. In most countries, wage-earners managed to resist a fall in real incomes but through the recession consumption grew in real terms by less than personal incomes because of a rise in saving ratios. Businesses cut back sharply on investment in fixed assets and stocks. Personal sectors' financial surpluses rose in 1975, and company sectors' financial deficits fell. The counterpart was seen mainly in a large increase in public sectors' deficits, brought about by the recession, which in turn was induced as much by the collapse of private sector confidence as by the direct effects of the OPEC surplus. Most forecasts suggest that this will not recur; and the evidence is so far consistent with this view. On the other hand, government policies are now significantly more restrictive, and the risk of a heavy recession remains.

# Assessment

The rate of inflation is not well measured by the twelve-month change in the retail price index (RPI), and the 22% increase it now shows over May a year ago overstates the acceleration that has occurred. Nevertheless, even when reasonable corrections are made, the pace of inflation is roughly double what it was, briefly, at the low point in 1978. This can in part be regarded as the rebound from a period of pay restraint. An important part also was due to the recent rise in the price of oil, and of other commodities, which has caused inflation to accelerate not only in this country, but world wide. This assessment reviews the present position in the light of these developments, and seeks to gauge how hard is the task for the future.

## The world-wide impact of oil price increases . . .

Measured in terms of its impact on the world economy, the rise in the price of oil over the last eighteen months has been of the same order as in 1973–74 — representing an immediate withdrawal of purchasing power, and injection of cost inflation, of about 2% of OECD countries' GNP. Even more important last time was the behaviour of the private economy. Cutbacks in investment and stocks, together with an upward step in savings rates in many countries, may have reduced total demand by another 5%. Much of the fall in private demand was offset by fiscal effects — either automatic reactions to recession, or, in many countries, as a result of deliberate policies to counter it.

It is difficult to say whether the international recession now in prospect will be less deep than last time. Because of greater awareness of the inflationary dangers, fiscal policy, far from being compensatory, is now restrictive in many countries; oil producers, too, may well be slower to spend their increased revenues. On the other hand, savings rates may not again jump as they did last time. Furthermore, in striking contrast to this country, wages in most major overseas countries have hardly accelerated, and profits may have been better maintained; this may weaken consumer demand, but in many countries industry may start in a stronger position to weather the recession. Equally important, less inflation — in most countries, but not here — has been built into domestic costs.

## . . . and their threat to growth in the 80s

The uncertainties of the oil situation, which are interrupting growth now, also cast a shadow over longer-term world prospects. The recent rise in the price of oil was triggered by the effects of the revolution in Iran, which caused widespread fears of shortage. In fact, however, production last year, both in OPEC countries and elsewhere, was higher than the year before. World consumption probably showed little change; but total demand increased because of precautionary stockbuilding by importing countries. For each country singly, that was rational and inevitable; taken as a whole, it was the cause of much of the pressure on prices.

It seems probable that instabilities in the price, downward or upward, will recur. The risk is that each period of faster growth will produce a surge in the price of oil. The dangers of inflation being now more clearly seen, countries are likely to be quick to cut back demand each time. It seems only too possible that economic development in the decade ahead will be dominated and throttled by these fears and risks.

Even if the basic trend of energy prices is upward, as seems possible, the recurrence of periodic falls would blunt the incentive to investment in energy saving and alternative energy sources, which, on a longer view, is vital on political as well as economic grounds. In theory it might be better for consuming countries if such development could take place without their having to pay so high a price for oil. In practice, however, adequate development of alternative energy sources seems unlikely unless there are firm expectations regarding the real price for oil. There may therefore be a conflict between the short-term and long-term interests of consuming countries. On a short-term view, a lower price would be clear gain, both for the terms of trade and for the control of inflation; and the latter consideration applies to this country as much as others, notwithstanding that it will be a net exporter. Longer-term considerations may suggest that it might be to the advantage of consuming countries if the real price were to remain fairly stable.

Possession of North Sea oil does not isolate the United Kingdom from these risks. If the rest of the world grows only slowly out of experience or fear of recurrent bouts of oil-induced inflation, it is unlikely that this country will find means of growing at more than a restricted pace. Success here in bringing inflation down, and the vigour of the recovery from the present recession, depend not only on our policies but also on the international situation.

## Inflation in this country worse than elsewhere

The United Kingdom is likely to have a worse problem than most other countries — a worse inflation and worse recession. The reasons why this should be so have clear lessons for the future.

In 1978 inflation in the United Kingdom was little faster than in the average OECD country; since then, relative performance has worsened. But the low point in 1978 overstated the deceleration in the underlying inflation rate. Wage inflation, with the breakdown of pay restraint, was then already accelerating; and this has continued — in part as a result of strong pressures to restore differentials distorted by incomes policies. The size of recent comparability awards in the public sector was, for example, determined by events in that earlier period.

Some of the factors behind the recent rise in retail prices are now changing. These include the effect of policy measures, of which the largest was the VAT increase in the June 1979 Budget; being accompanied by roughly equivalent reductions in income tax, this represented no more than a switch in taxation. By July this year that effect, which increased the RPI by 3%–4%, will have dropped out of the twelve-month comparison. Later, the twelve-month increase should show a further falling away, as the surge in oil and commodity prices similarly recedes into the past — all the more if world commodity prices now fall.

The acceleration of prices has also reflected the faster growth in wages in this and the previous wage round — whose effects, unfortunately, will also tend to show up in retail prices over the year ahead. By the end of July, at the end of this round, the twelve-month rise in earnings may be only slightly ahead of the RPI increase (at the lower figure at which it will then be). Some two to three percentage points of the rise in earnings overall will be due to the Clegg and other awards in the public sector. In the private sector as a whole, wage earnings may show an increase more or less in line with the

rise in prices, and in manufacturing somewhat less. This degree of restraint should be helpful in slowing down the subsequent rise in prices. But any such restraint of wages in face of price increases has clearly been less than in many other countries — an indication that inflationary rigidities have got more deeply entrenched in this country than elsewhere, and that the policy required to break inflationary expectations may have to be more severe.

Firms have found their profits decline, in part as a result of large wage increases. Another factor has been that the growth of demand last year — fairly rapid in this country as in most others — hardly benefited domestic output. Most went to imports, and thus to support profits not in this country but in others. Industry may therefore be now forced to make a more drastic adjustment. Other forces working in the same direction are fiscal restraint, and the level of nominal interest rates that has been required, at a time of high inflation, to maintain monetary control — and the consequence this has for the exchange rate.

Government fiscal and monetary policies are designed to bring about a progressive reduction of inflation, and need to be continued till that end is accomplished: a less restrictive posture of policy would clearly be inappropriate at a time when inflation is so high. Weaker demand should help to moderate inflation; but recession is coming later than expected, and the full effects on wages and prices may not be seen for some time. The influence of monetary restraint can only be gradual and pervasive, with effects to be looked for over a period of years. In the recent period, this influence has been overlaid by the series of special factors already discussed.

## The task of reducing inflation

Wages will need for a while to increase less rapidly than prices; this would in fact provide the best prospect for future increases in real wages. The rise in prices could be tempered by an increase in productivity, and a large increase would greatly help; but it can hardly be counted on to come about quickly. The rise in prices would also be moderated if profits were squeezed further. But profits are already too low—partly in consequence of big wage increases in the past; and any further reduction, disastrous for future investment and growth, would be insufficient to slow down inflation much. In practice, a significant slowing down of price inflation will entail a temporary fall in real wages. Though real wages have tended to increase in most years, there should be no presumption that this can happen in every year, and that real wages will never fall back. That kind of rigid linkage would provide altogether too little flexibility to the economic system for necessary adjustments to be made. In the last two years, earnings have gone up substantially more than prices — by well over 5% if the June 1979 indirect tax increases are discounted. Manufacturers' labour costs, too, have risen faster than the prices they received — by an even wider margin. To get inflation down within a reasonable period it may be necessary for something like that gain to be reversed in the short term. That would entail restraint in the public as well as the private sector.

A counter-inflationary policy can only work by providing a framework of financial stability over the medium term: the costs in the transition period depend, above all, on how quickly expectations generally, and more particularly firms' ideas of the wage increases they can afford to pay, adjust to the monetary environment. It is therefore highly important that wage increases in the next round

should be well below the present one. It would indeed greatly reduce the pain and duration of the adjustment if pay settlements were now to be in line with the monetary target.

There are some indications, as noted above, that wage increases, especially in manufacturing, have already been restrained by weak conditions of demand; and by the next wage round, this restraint should be stronger. There is therefore hope that the increase in earnings in the next round will in fact be appreciably less than the increase in retail prices — significantly reduced as that will be by the early stages of the round. It would then be possible to envisage a substantial reduction in the rate of inflation through 1981.

## The difficulties faced by industry

A recession is bound to create difficulties for industry. The conditions which have necessitated present policies may take time to change. It is therefore important to consider how far the impact of policies on the economy will soften as the situation evolves and as inflation is brought under control.

To some considerable extent, the probability of recession stems — in this country as elsewhere — from the rise in the price of oil. But this country is of course differently placed from others in that it has its own oil, and thus suffers no terms of trade loss when the world price of oil rises. The immediate impact is to reduce consumers' purchasing power; but profits from the North Sea will rise. Some of the benefit will flow to foreign owners of North Sea developments, but most will accrue to residents. Indeed, about three quarters of the revenue from the recent increase in oil prices will accrue to the Government over the next five years as royalty or tax, thus accelerating the build-up of government North Sea revenues. Alleviations of other types of taxation should therefore later be possible, which would then both raise consumer purchasing power again and ease industry's position; and the Government's medium-term financial strategy envisages that there should later be scope for fiscal adjustment.

## Exchange rate uncertainties

The strength of the exchange rate results from the combination of many factors, whose effect is difficult to predict. Notwithstanding explanations which can be offered after the event, there appears to be a substantial degree of indeterminacy in its level. It clearly owes much to the large volume of international money, increased by higher oil prices, seeking investment; and by the fact that, amid the many uncertainties in the international situation, this country's balance of payments on current account — unlike most others' — is little affected by changes in the price of oil. More recently it has been affected by the rapid fall in US interest rates, in conjunction with the high level of nominal interest rates in this country which, to outside investors, have appeared attractive — more especially at a time when the exchange rate has demonstrated a tendency, on balance, to continue to rise.

## Monetary policy and interest rates

The present stage of the cycle places a strain on monetary policy, since finance has to be provided both for high public deficits — though steps have been taken to rein back public expenditure — and for industrial needs which at the moment also continue high. To maintain monetary control despite these pressures has required

interest rates which are high in nominal terms. But they are not high in relation to the rate of inflation, or as compared with what might have been expected given the juxtaposition of a monetary target with a rate of increase in money incomes twice as large.

Industrial demand for bank credit should be reduced in the course of recession. It is usually argued that the first result of recession is to increase industry's need to borrow. Firms have to carry large stocks which they would like to liquidate; but this takes time under conditions where customers earlier and later in the chain of production are seeking to do the same. But in time there should be a reassessment, both on the part of firms of what it is wise to borrow, and on the part of banks as to what it is right to lend. Many firms have had relatively poor profit expectations, but are now in addition having to gauge the likely impact of recession.

If the pace of monetary expansion slackens, as a result perhaps of a smaller scale of bank lending, the task of monetary control would ease; and the growth of sterling $M_3$ may moderate to an extent which permits falls in interest rates. Larger possibilities of lower interest rates will open up as inflation falls off.

## Conclusion: the longer-term problems

Beyond the problem of inflation there are longer-term problems for the economy. These are to some extent independent of inflation, and will remain when that has been mastered. Even before the advent of North Sea oil, there has long been evidence of a need for improved performance and increased flexibility; our position as an oil producer increases the need for structural adaptation. Though urgent, that process is, in degree, impeded until inflation can be brought under control. That remains the first need; and fiscal and monetary policies must continue to be directed, first, to reducing inflation.